

GAO

## Testimony

Before the Subcommittee on Government Efficiency,  
Financial Management, and Intergovernmental Relations,  
Committee on Government Reform, House of  
Representatives

---

For Release on Delivery  
Expected at 10 a.m.  
Tuesday, April 9, 2002

# U.S. GOVERNMENT FINANCIAL STATEMENTS

## FY 2001 Results Highlight the Continuing Need to Accelerate Federal Financial Management Reform

Statement of David M. Walker  
Comptroller General of the United States



## Report Documentation Page

<b>Report Date</b> 00APR2002	<b>Report Type</b> N/A	<b>Dates Covered (from... to)</b> -
<b>Title and Subtitle</b> U.S. GOVERNMENT FINANCIAL STATEMENTS: FY 2001 Results Highlight the Continuing Need to Accelerate Federal Financial Management Reform	<b>Contract Number</b>	
	<b>Grant Number</b>	
	<b>Program Element Number</b>	
<b>Author(s)</b>	<b>Project Number</b>	
	<b>Task Number</b>	
	<b>Work Unit Number</b>	
<b>Performing Organization Name(s) and Address(es)</b> U.S. General Accounting Office P.O. Box 37050 Washington, D.C. 20013	<b>Performing Organization Report Number</b> GAO-02-599t	
<b>Sponsoring/Monitoring Agency Name(s) and Address(es)</b>	<b>Sponsor/Monitor's Acronym(s)</b>	
	<b>Sponsor/Monitor's Report Number(s)</b>	
<b>Distribution/Availability Statement</b> Approved for public release, distribution unlimited		
<b>Supplementary Notes</b>		
<b>Abstract</b> I am pleased to be here today to discuss our report on the U.S. governments consolidated financial statements for fiscal years 2001 and 2000. Both the consolidated financial statements and our report are included in the fiscal year 2001 Financial Report of the United States Government, which was issued by the Department of the Treasury (Treasury) on March 29, 2002, and is available through GAOs Internet site, at <a href="http://www.gao.gov">www.gao.gov</a> . Your work and that of this subcommittee have been a catalyst to facilitate government management reform over the past 5 years and will be critical to ultimately restoring the confidence of citizens in the federal government as a financial steward that is accountable for its finances.		
<b>Subject Terms</b>		
<b>Report Classification</b> unclassified	<b>Classification of this page</b> unclassified	
<b>Classification of Abstract</b> unclassified	<b>Limitation of Abstract</b> SAR	
<b>Number of Pages</b> 44		

---

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our report on the U.S. government's consolidated financial statements for fiscal years 2001 and 2000. Both the consolidated financial statements and our report are included in the fiscal year 2001 *Financial Report of the United States Government*, which was issued by the Department of the Treasury (Treasury) on March 29, 2002, and is available through GAO's Internet site, at [www.gao.gov](http://www.gao.gov). Your work and that of this subcommittee have been a catalyst to facilitate government management reform over the past 5 years and will be critical to ultimately restoring the confidence of citizens in the federal government as a financial steward that is accountable for its finances.

As in the 4 previous fiscal years, we were unable to express an opinion on the consolidated financial statements because of certain material weaknesses in internal control and accounting and reporting issues. These conditions prevented us from being able to provide the Congress and American citizens an opinion as to whether the consolidated financial statements are fairly stated in conformity with U.S. generally accepted accounting principles.

Until the problems discussed in our report are adequately addressed, they will continue to (1) hamper the government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the government's ability to adequately safeguard certain significant assets and properly record various transactions.

Progress is being made in addressing impediments to an unqualified opinion on the U.S. government's consolidated financial statements. For example, in fiscal year 2001, the Department of Agriculture (USDA) and certain other key agencies made significant improvements in estimating the cost of the government's lending programs and the net loan amounts expected to be collected, which had contributed to our disclaimer of opinion in prior years. However, many of the pervasive and generally long-standing material weaknesses we have reported for the past 4 years have not been fully resolved. The underlying causes of these issues are significant financial management systems weaknesses, problems with

---

fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control.

Across government, there are a range of financial management improvement initiatives underway that, if effectively implemented, will improve the quality of the government's financial management and reporting. For fiscal year 2001, 18 of the 24 Chief Financial Officers (CFO) Act agencies were able to attain unqualified audit opinions on their financial statements, which is the same number of agencies as last year and up from 6 agencies for fiscal year 1996. Also, the Office of Management and Budget (OMB) reported that, for the second consecutive year, all 24 CFO Act agencies met the statutory reporting deadline. Further, two agencies that did not receive unqualified opinions from their auditor last year were able to do so this year, including the Department of Justice, which received an unqualified opinion for the first time. However, two other agencies were unable to sustain the unqualified opinions received from their auditor last year. Additionally, for fiscal years 2001 and 2000, reports of inspectors general and their contract auditors indicated that only 3 of the 24 CFO Act agencies had neither a material control weakness, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

The largest impediment to an unqualified opinion on the consolidated financial statements continues to be the Department of Defense's (DOD) serious financial management problems, which we have designated as high risk since 1995. DOD faces financial management problems that are pervasive, complex, long-standing, and deeply rooted in virtually all business operations throughout the department. To date, none of the military services or major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in financial management systems, operations, and controls. Overhauling financial management represents a major management challenge that goes far beyond financial accounting to the very fiber of the department's business operations and management culture. Cultural resistance to change and military service parochialism have played a significant role in impeding previous attempts to implement broad-based management reforms at DOD. The department has acknowledged that it confronts decades-old problems deeply grounded in the bureaucratic history and operating practices of a complex, multifaceted organization, and that many of these practices were developed piecemeal and evolved to accommodate different organizations, each with its own policies and procedures. In September 2001, Secretary of

---

Defense Rumsfeld announced a DOD-wide initiative intended to transform the full range of the department's business processes, including decades-old financial systems that are not well interconnected. For the first time, the *Quadrennial Defense Review* prepared by DOD includes business process transformation as a key element. The Secretary has also taken action to set aside \$100 million for financial modernization and to establish a number of top-level committees, councils, and boards, including the Business Initiative Council and the Defense Business Practices Implementation Board, to help develop and implement an integrated DOD-wide strategy for fundamentally transforming business practices.

Two other major impediments that must be overcome are the government's inability to account for billions of dollars of transactions between federal government entities and to properly prepare the consolidated financial statements. The heart of the intragovernmental transactions issue is that the government lacks clearly articulated business rules for these transactions so that they are handled consistently by agencies. Compounding this problem, agencies have not reconciled intragovernmental balances with their trading partners.<sup>1</sup> As a result, information reported to Treasury is not reliable. OMB and Treasury have several initiatives underway to address this issue. With respect to properly preparing the consolidated financial statements, Treasury plans to develop a new system and procedures to prepare the financial statements. The continued leadership of both OMB and Treasury will be important to resolving both of these issues.

Many agencies have been able to obtain unqualified audit opinions only by expending significant resources on extensive ad hoc procedures and making billions of dollars in adjustments to derive financial statements months after the end of a fiscal year. As I previously testified<sup>2</sup> before this subcommittee, if agencies continue year after year to rely on significant costly and time-intensive manual efforts to achieve or maintain unqualified opinions without improving underlying financial management systems, it can serve to mislead the public as to the true status of the agency's financial

---

<sup>1</sup>Trading partners are U.S. government agencies, departments, or other components included in the U.S. government's consolidated financial statements that do business with each other.

<sup>2</sup>U.S. General Accounting Office, *U.S. Government Financial Statements: FY 2000 Reporting Underscores the Need to Accelerate Federal Financial Management Reform*, GAO-01-570T (Washington, D.C.: Mar. 30, 2001).

---

management capabilities. An unqualified opinion achieved on this basis will become an accomplishment without much substance.

Irrespective of the unqualified opinions on their financial statements, many agencies do not have timely, accurate, and useful financial information, including cost data, and do not have sound controls with which to make informed decisions and ensure accountability on an ongoing basis. For example, for fiscal year 2001, auditors for 17 of the 24 CFO Act agencies reported at least one material control weakness, compared to 15 such agencies for fiscal year 2000. In addition, for fiscal year 2001, reports of inspectors general and their contract auditors indicated that 20 of the 24 CFO Act agencies' financial management systems were not in substantial compliance with at least one of FFMA's three federal financial management systems requirements, compared to 19 such agencies for fiscal year 2000. For the remaining four CFO Act agencies (the Departments of Energy and Labor, the General Services Administration (GSA), and the Social Security Administration (SSA)), auditors provided negative assurance, meaning that nothing came to their attention indicating these agencies' financial management systems do not meet FFMA requirements. The auditors for these four agencies did not definitively state whether these agencies' systems substantially complied with FFMA's requirements, which we believe is required under the statute. Ultimately, to fully meet the goals of financial management reform legislation, agencies will need to be able to generate timely, accurate, and useful financial and management information, including reporting performance results, to make decisions and monitor government performance every day. Agencies will also need to have effective internal controls in place and must ensure compliance with applicable laws and regulations.

*The President's Management Agenda Fiscal Year 2002* includes improved financial management performance as one of his five top governmentwide management goals. Other governmentwide initiatives include strategic management of human capital, competitive sourcing, expanded electronic government, and budget and performance integration. These initiatives cannot be addressed in an isolated or piecemeal fashion, but must be addressed in an integrated way to ensure that they drive a broader transformation of the cultures of federal agencies. The administration plans to use the Executive Branch Management Scorecard, which includes broad standards, to highlight agencies' progress in achieving management and performance improvements embodied in *The President's Management Agenda Fiscal Year 2002*. This is a step in the right direction to improving management and performance, but the value of the scorecards is not in the

---

scoring, but in the degree to which scores lead to sustained focus and demonstrable improvements. It will be important that there be continuous rigor in the scoring process in order for this approach to be credible and effective.

In August 2001, the Principals of the Joint Financial Management Improvement Program (JFMIP)—Secretary of the Treasury O’Neill, Office of Management and Budget Director Daniels, Office of Personnel Management (OPM) Director James, and I, as Comptroller General of the United States and chair for the group—began a series of periodic meetings that have resulted in unprecedented substantive deliberations and agreements focused on key financial management reform issues such as better defining measures for financial management success. These measures include being able to routinely provide timely, accurate, and useful financial information and having no material internal control weaknesses or material noncompliance with laws and regulations and FFMIA requirements, which are essential to meeting the CFO Act’s expectations, *The President’s Management Agenda Fiscal Year 2002*, and Secretary of Defense Rumsfeld’s business process transformation initiative. In addition, the JFMIP Principals have agreed to significantly accelerate financial statement reporting so that the government’s financial statements are more timely and to discourage costly efforts designed to obtain unqualified opinions on financial statements without addressing underlying systems challenges. For fiscal year 2004, audited agency financial statements are to be issued no later than November 15, with the U.S. government’s audited consolidated financial statements becoming due by December 15.

Federal agencies have started to make progress in their efforts to modernize their financial management systems. However, the need for timely, accurate, and useful financial and performance management information is greater than ever given the increasing demands on the federal budget.<sup>3</sup> Indeed, the challenges of combating terrorism and ensuring our homeland security have come to the fore as urgent claims on

---

<sup>3</sup>Additionally, beginning on April 4, 2002, the Secretary of the Treasury exercised statutory authority to suspend some investments and reinvestments of the Federal Employees Retirement System’s Government Securities Investment Fund’s (G-Fund) receipts and maturing securities to prevent Treasury from exceeding the government’s current \$5,950 billion debt ceiling. The Secretary reported that the G-Fund will receive complete restoration of all funds temporarily affected by this action, including full and automatic restoration of any interest that would have been credited to the Fund.

---

our attention and on the federal budget. At the same time, the known fiscal pressures created by the retirement of the baby boom generation and rising health care costs remain. Correspondingly, the ultimate task of addressing today's needs without unduly exacerbating the long-range fiscal challenge has become much more difficult.

As we look ahead we face an unprecedented demographic challenge. A nation that has prided itself on its youth will become older. In fact, in 2008—only 6 years from now—the first wave of baby boomers become eligible to claim their Social Security benefits. As the share of the population over 65 climbs to more than 20 percent in 2035, federal spending on the elderly will absorb larger and ultimately unsustainable shares of the federal budget. Federal health and retirement spending are expected to surge as people live longer and spend more time in retirement. In addition, advances in medical technology are likely to keep pushing up the cost of providing health care. Absent substantive reform of these entitlement programs, a rapid escalation of federal spending for Social Security, Medicare, and Medicaid is virtually certain to overwhelm the rest of the federal budget.

On March 26, 2002, the Trustees of the Social Security and Medicare trust funds reported on the current and projected status of these programs over the next 75 years. The Trustees' reports highlight the need to address the long-term fiscal challenges facing the nation. The Trustees state that, while the near-term financial conditions have improved slightly since last year's reports, the programs continue to face substantial financial challenges in the not-too-distant future that need to be addressed soon. Once again, the Trustees underscored the fact that the most significant implication of these findings is that both Social Security and Medicare need to be reformed and strengthened at the earliest opportunity. The Trustees also stated that Medicare faces financial difficulties that in many ways are more severe than those confronting Social Security.

These long-term demographic and fiscal pressures and the new commitments undertaken after September 11 sharpen the need to look at competing claims and new priorities. While reforming health and retirement entitlement programs is essential to preserving fiscal flexibility in the long term, a fundamental review of all programs and operations can create much-needed fiscal flexibility to address emerging needs and unexpected requirements. Given our long-range budget simulation work and various key trends, there is a clear and compelling need to consider

---

what the proper role of the federal government should be in the 21st century and how the government should do business in the future.

Timely, accurate, and useful financial and performance information can form the basis for reconsidering the relevance or “fit” of any federal program or activity in today’s world and for the future. Such a review might identify programs that have proven to be outdated or persistently ineffective, or alternatively could prompt the government to update and modernize activities through such actions as improving program targeting and efficiency, consolidation, or reengineering processes and operations. The budget and performance integration initiative under *The President's Management Agenda Fiscal Year 2002* should help provide information for use in conducting such a review. In addition, any review should not be limited to only spending programs but should include the full range of more indirect tools of governance that the federal government uses to address national objectives. These tools include loans and loan guarantees, tax expenditures, and regulations. Ultimately, we should strive to hand to the next generation the legacy of a government that is effective, respected, responsive, and relevant to a changing society—a government that is as free as possible from outmoded commitments and operations that can inappropriately encumber the future.

The Congress and President Bush face the challenge of sorting out these many claims on the federal budget without the fiscal benchmarks that guided us through the years of deficit reduction into surplus. Going forward, new rules and goals will be important both to ensure fiscal discipline and to prompt a focus on the longer term implications of decisions. It is still the case that the federal government needs a decision-making framework that permits it to evaluate choices against both today’s needs and the longer term fiscal future that will be handed to future generations. As stewards of our nation’s future, we must begin to prepare for tomorrow. In this regard, we must determine how best to address these structural challenges in a reasonably timely manner in order to identify specific actions that need to be taken.

I would now like to highlight the major issues relating to the U.S. government’s consolidated financial statements for fiscal years 2001 and 2000. I will then discuss the urgency of providing sustained leadership and oversight to accelerate financial management reform, provide my perspectives on the importance of agencies’ building upon their unqualified audit opinions by significantly improving underlying financial management systems, and underscore the need to address major impediments to an

---

unqualified opinion on the consolidated financial statements. Also, I will present my observations on selected audit matters that are essential to protect the public interest and conclude with a few thoughts on several key challenges in preparing to meet tomorrow's fiscal needs.

---

## Highlights of Major Issues Relating to the U.S. Government's Consolidated Financial Statements for Fiscal Years 2001 and 2000

As I mentioned earlier, as has been the case for the past 4 fiscal years, a significant number of material weaknesses<sup>4</sup> related to financial systems, fundamental recordkeeping and financial reporting, and incomplete documentation continued to (1) hamper the government's ability to accurately report a significant portion of its assets, liabilities, and costs, (2) affect the government's ability to accurately measure the full cost and financial performance of certain programs and effectively manage related operations, and (3) significantly impair the government's ability to adequately safeguard significant assets and properly record various transactions. Several of these material weaknesses (referred to hereafter as material deficiencies) resulted in conditions that continued to prevent us from expressing an opinion on the U.S. government's consolidated financial statements for the fiscal years ended September 30, 2001 and 2000.<sup>5</sup> There may also be additional issues that could affect the consolidated financial statements that have not been identified.

Major challenges include the federal government's inability to

- properly account for and report property, plant, and equipment and inventories and related property, primarily at DOD;
- use effective processes and procedures to estimate the cost of certain major federal credit programs and the related loans receivable and loan guarantee liabilities;

---

<sup>4</sup>A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis.

<sup>5</sup>We previously reported that material deficiencies prevented us from expressing an opinion on the U.S. government's consolidated financial statements for fiscal years 1997, 1998, and 1999.

- 
- support amounts reported for certain liabilities, such as environmental and disposal liabilities and related costs at DOD, and ensure complete and proper reporting for commitments and contingences;
  - support major portions of the total net cost of government operations, most notably related to DOD and USDA, and ensure that all disbursements are properly recorded;
  - fully account for and reconcile intragovernmental activity and balances; and
  - properly prepare the federal government's financial statements, including balancing the statements, eliminating substantial amounts of transactions between governmental entities, fully ensuring that the information in the consolidated financial statements is consistent with the underlying agency financial statements, and adequately reconciling the results of operations to budget results.

In addition, we identified material weaknesses in internal control related to improper payments, tax collection activities, and computer security. Further, the financial management systems of most CFO Act agencies were again reported by their auditors not to be in substantial compliance with certain FFMIA requirements.

For the fiscal year 2001 *Financial Report of the United States Government*, the government has for the first time presented: (1) comparative financial statements;<sup>6</sup> (2) two new financial statements, namely, the Reconciliations of Net Operating Revenue/(Cost) to the Budget Surplus (Unaudited), and the Dispositions of the Budget Surplus (Unaudited); and (3) a Statement of Net Cost that arrays information classified by agency rather than by function, as was shown in prior years.

I would now like to discuss in more detail the material deficiencies identified by our work.

---

<sup>6</sup>Numerous amounts previously reported for fiscal year 2000 have been restated in the U.S. government's consolidated financial statements for fiscal years 2001 and 2000. Given our disclaimer of opinion on the U.S. government's consolidated financial statements for fiscal year 2000 and because the dollar amounts involved were not material, we did not audit these changes.

---

Property, Plant, and Equipment  
and Inventories and Related  
Property

The government could not: satisfactorily determine that all such assets were included in the consolidated financial statements, verify that certain reported assets actually exist, or substantiate the amounts at which they were valued. A majority of the property, plant, and equipment and inventories and related property is the responsibility of DOD. Certain agencies, including DOD, did not maintain adequate systems or have sufficient records to provide reliable information on these assets.

Loans Receivable and Loan  
Guarantee Liabilities

For fiscal year 2000, certain federal credit agencies responsible for significant portions of the government's lending programs, most notably USDA, were unable to properly estimate the cost of these programs, or estimate the net loan amounts expected to be collected, in conformity with U.S. generally accepted accounting principles and budgeting requirements. In fiscal year 2001, USDA and other key agencies made significant improvements to these estimates, and as a result, this item is not a material deficiency contributing to our disclaimer of opinion on the fiscal year 2001 consolidated financial statements. However, significant adjustments to the initial estimates of program costs, net loan amounts to be collected, and related footnotes were required during the audit process at certain key agencies, indicating that material internal control weaknesses continue to exist in processes and procedures for making such estimates.

Liabilities and Commitments and  
Contingencies

The government could not adequately support amounts reported for certain liabilities. For example, it could not develop an accurate estimate of key components of DOD's environmental and disposal liabilities and accurately estimate military postretirement health benefits liabilities included in federal employee and veteran benefits payable, which were reported at \$581 billion in fiscal year 2001 and \$192 billion in fiscal year 2000.<sup>7</sup> In addition, the government could not determine whether commitments and contingencies, including those related to treaties and other agreements entered into to further the U. S. government's interests, were complete and properly reported.

Cost of Government Operations  
and Disbursement Activity

The previously discussed material deficiencies in reporting assets and liabilities, material deficiencies in financial statement preparation, as

---

<sup>7</sup>For fiscal year 2001, the military postretirement health benefits liability increased by \$389 billion due primarily to (1) a \$293 billion increase attributable to provisions of the fiscal year 2001 National Defense Authorization Act (Public Law 106-398) that expand certain benefits to Medicare-eligible DOD retirees, their dependents, and survivors, and (2) a \$91 billion increase associated with changes in medical trend assumptions.

---

discussed below, and the lack of effective agency disbursement reconciliations affect reported net costs. As a result, the government was unable to support significant portions of the total net cost of government operations, most notably related to DOD and USDA. As it relates to disbursement reconciliations, several major agencies did not effectively reconcile disbursements to Treasury's records of disbursements, which is intended to be a key control to detect and correct errors and other misstatements in financial records in a timely manner. This is similar in concept to individuals reconciling their checkbooks with their bank statements each month. Although we have seen progress in this area over the past 5 years, there continued to be billions of dollars of unreconciled differences between agencies' and the Treasury's records of disbursements as of September 30, 2001 and 2000, which could also affect the balance sheet.

Accounting for and  
Reconciliation of  
Intragovernmental Activity and  
Balances

For several years, OMB and Treasury have required the CFO Act agencies to reconcile selected intragovernmental activity and balances with their trading partners. However, numerous agencies did not fully perform such reconciliations for fiscal years 2001 and 2000. For these fiscal years, amounts reported for agency trading partners for certain intragovernmental accounts were significantly out of balance. I will further discuss these issues later in this testimony.

Preparation of Consolidated  
Financial Statements

The government did not have adequate systems, controls, and procedures to properly prepare its consolidated financial statements. Specifically, we identified problems with the elimination of intragovernmental activity and balances, reconciling operating results with budget results, and compiling the consolidated financial statements, such as adequately ensuring that the information for each agency that was included in the consolidated financial statements was consistent with the underlying agency financial statements. These matters are discussed further later in this testimony. Also, disclosure of certain financial information was not presented in the consolidated financial statements in conformity with U.S. generally accepted accounting principles.

---

Ineffective Internal Control

In addition to the material deficiencies noted above, we found that (1) most agencies have not estimated the magnitude of improper payments in their programs, (2) material internal control weaknesses and systems deficiencies continue to affect the government's ability to effectively

---

manage its tax collection activities, and (3) widespread and serious computer control weaknesses affect virtually all federal agencies.

## Improper Payments

Across government, improper payments occur in a variety of programs and activities, including those related to health care, contract management, federal financial assistance, and tax refunds, and include payments made for unauthorized purposes and for excessive amounts, such as overpayments to program recipients or contractors and vendors. The reasons for improper payments range from program design issues, to inadvertent errors, to fraud and abuse. While reported estimates of improper payments totaled approximately \$19 billion for both fiscal years 2001 and 2000, the government did not estimate the full extent of improper payments.

The Department of Health and Human Services (HHS) has been reporting a national estimate of improper Medicare Fee-for-Service payments as part of its annual financial statements since fiscal year 1996. In fiscal year 2001, HHS reported estimated improper Medicare Fee-for-Service payments of \$12.1 billion, or about 6.3 percent of such benefits—up from \$11.9 billion, or 7 percent, a year earlier and down from \$23.2 billion, or 14 percent, for fiscal year 1996. HHS's reporting and analysis of improper Medicare payments has helped lead to the implementation of several initiatives to identify and reduce such payments. Annual estimates of improper payments in future audited financial statements will provide information on the progress of these initiatives.

However, most agencies have not estimated the magnitude of improper payments in their programs and comprehensively addressed this issue in their annual performance plans under the Government Performance and Results Act (GPRA) of 1993.<sup>8</sup> For example, the Internal Revenue Service (IRS) follows up on only a portion of the suspicious Earned Income Tax Credit (EITC) claims it identifies, although the EITC has historically been vulnerable to high rates of invalid claims. During fiscal year 2000, IRS released the results of its study of EITC compliance for tax year 1997. In this study, which is not performed annually, IRS estimated that taxpayers filed returns claiming about \$9.3 billion in invalid EITCs, of which \$1.5 billion (16 percent) either was recovered or was expected to be recovered through compliance efforts. Although the full extent of refunds

---

<sup>8</sup>U.S. General Accounting Office, *Financial Management: Billions in Improper Payments Continue to Require Attention*, GAO-01-44 (Washington, D.C.: Oct. 27, 2000).

---

resulting from invalid EITCs is unknown, the IRS has not routinely estimated the potential magnitude of invalid refunds and has not disclosed an annual estimate of improper payments in its financial reports. As a result, the amount of improper payments included in the almost \$26 billion IRS disbursed for EITC in fiscal year 2001 is unknown.

Without a systematic measurement of the extent of improper payments, agency management cannot determine (1) if the problem is significant enough to require corrective action, (2) how much to invest in preventative internal control, (3) the success of efforts implemented to reduce improper payments, or (4) the magnitude or trends of improper payments, which limits the ability to pinpoint or target mitigation strategies. To help in making such determinations, OMB now requires agencies to provide information on erroneous payment rates for benefit and assistance programs expending over \$2 billion annually.

## Tax Collection Activities

Material internal control weaknesses and systems deficiencies continue to affect the government's ability to effectively manage its tax collection activities.<sup>9</sup> This situation continues to result in the need for extensive, costly, and time-consuming ad hoc programming and analyses, as well as material audit adjustments, to prepare basic financial information. As further discussed later in this testimony, this approach cannot be used to prepare such information on a timely, routine basis to assist in ongoing decision-making. Additionally, the severity of the system deficiencies that give rise to the need to resort to such procedures for financial reporting purposes, as well as deficient physical safeguards, result in burden on taxpayers and lost revenue.

The lack of appropriate subsidiary systems to track the status of taxpayer accounts and material weaknesses in financial reporting affect the government's ability to make informed decisions about collection efforts. Due to errors and delays in recording activity in taxpayer accounts, taxpayers were not always being credited for payments made on their tax liabilities. In addition, the government did not always follow up on potential unreported or underreported taxes and did not always pursue collection efforts against taxpayers owing taxes to the federal government. This could result in billions of dollars not being collected and adversely affect future compliance.

---

<sup>9</sup>U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

---

The federal government continues to be vulnerable to lost tax revenue due to weaknesses in controls intended to maximize the government's ability to collect what is owed and to minimize the risk of payment of improper refunds. The government identifies billions of dollars of potentially underreported taxes and improper refunds each year. However, due in large part to perceived resource constraints, the federal government selects only a portion of the questionable cases it identifies for follow-up investigation and action. In addition, the federal government often does not initiate follow-up on the cases it selects until months after the related tax returns have been filed and any related refunds disbursed, affecting its chances of collecting amounts due on these cases. Consequently, the federal government is exposed to potentially significant losses from reduced revenue and disbursements of improper refunds. Finally, continued weaknesses in physical controls over cash, checks, and sensitive data received from taxpayers increase both the government's and the taxpayers' exposure to losses and increases the risk of taxpayers becoming victims of crimes committed through identity fraud.

IRS senior management continues to be committed to addressing many of these operational and financial management issues and has made a number of improvements to address some of these weaknesses. Successful implementation of long-term efforts to resolve these serious problems will require the continued commitment of IRS management as well as substantial resources and expertise.

## Computer Security Weaknesses

GAO has reported computer security as a governmentwide high-risk area since February 1997.<sup>10</sup> Computer security weaknesses are placing enormous amounts of government assets at risk of inadvertent or deliberate misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. The government is not in a position to estimate the full magnitude of actual damage and loss resulting from federal computer security weaknesses because it is likely that many such incidents are either not detected or not reported. Agencies have not yet established comprehensive security management programs that would provide the government with a framework for resolving computer security problems and managing computer security risk on an ongoing basis.

---

<sup>10</sup>See, for example, U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: Jan. 2001).

---

The computer security weaknesses continue to cover the full range of computer security controls. For example, access controls were not effective in limiting or detecting inappropriate access to computer resources, such as ensuring that only authorized individuals can read, alter, or delete data. In addition, software change controls were ineffective in ensuring that only properly authorized and tested software programs were implemented. Further, duties were not appropriately segregated to reduce the risk that one individual could conduct unauthorized transactions without being detected. Finally, sensitive operating system software was not controlled, and adequate steps had not been taken to ensure continuity of operations.

As we recently testified, the initial implementation of government information security reform provisions contained in the National Defense Authorization Act for fiscal year 2001 is a significant step in improving federal agencies' information security programs and addressing their serious, pervasive information security weaknesses.<sup>11</sup> In its first report on the reform provisions, OMB commended agencies' improvement efforts but noted that many agencies have significant deficiencies in every important area of security. Agencies have noted benefits of this first-year implementation, including increased management attention to and accountability for information security. In addition, the administration has taken important actions to address information security, such as (1) development of plans to integrate information security into the Executive Branch Management Scorecard, which is discussed later in this testimony, (2) appointment of a Special Advisor for Cyberspace Security to coordinate interagency efforts to secure information systems, and (3) creation of the President's Critical Infrastructure Protection Board to recommend policies and coordinate programs, including government and industry's working closely together to address increasing interconnections and shared risks.

---

## Compliance with Applicable Laws and Regulations and FFMIA Requirements

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited by the material weaknesses discussed above. Instances of noncompliance, some of which the agency auditors reported were material to individual agency financial statements, are included in individual agency audit reports. However, none of these instances were material to the U.S. government's

---

<sup>11</sup>U.S. General Accounting Office, *Information Security: Additional Actions Needed to Fully Implement Reform Legislation*, GAO-02-470T (Washington, D.C.: Mar. 6, 2002).

---

consolidated financial statements. Additionally, as further discussed later in this testimony, for most CFO Act agencies, the auditors reported that agencies' financial management systems did not substantially comply with certain FFMIA requirements.

---

## Providing Sustained Leadership and Oversight to Accelerate Financial Management Reform

A year ago, in testimony<sup>12</sup> before this subcommittee on the U.S. government's consolidated financial statements, I said that Treasury Secretary O'Neill, OMB Director Daniels, and I (who, as I mentioned earlier, along with OPM Director James, are the JFMIP Principals) had agreed on the need for aggressive action to accelerate progress in financial management reform. This has sparked our personal commitment to provide the leadership necessary to address pressing governmentwide financial management issues. Also since that time, President Bush has launched a promising new initiative, *The President's Management Agenda Fiscal Year 2002*, to provide direction to, and to closely monitor, management reform across government, which will encompass improved financial performance. Actions such as these are important elements of ensuring the government's full and effective implementation of the federal financial management reforms enacted by the Congress.

---

## The JFMIP Principals' Initiative

Over the past year, the JFMIP Principals have established an excellent working relationship, a basis for action, and a new sense of urgency through which significant and meaningful progress can be achieved. In August 2001, the JFMIP Principals began a series of periodic meetings that marked the first time all four of the Principals had gathered together in over 10 years. To date, these sessions have resulted in substantive deliberations and agreements focused on key issues such as

- Defining success measures for financial management performance that go far beyond an unqualified audit opinion on financial statements and include measures such as financial management systems that routinely provide timely, reliable, and useful financial information and no material internal control weaknesses or material noncompliance with laws and regulations and FFMIA requirements;

---

<sup>12</sup>GAO-01-570T.

- 
- Restructuring the Federal Accounting Standards Advisory Board's (FASAB) composition to enhance the independence of the Board and increase public involvement in setting standards for federal financial accounting and reporting;
  - Significantly accelerating financial statement reporting so that the government financial statements are timely and to discourage costly efforts designed to obtain unqualified opinions on financial statements without addressing underlying systems challenges;
  - Establishing audit committees for the major federal agencies;
  - Addressing the impediments to an audit opinion on the U.S. government's consolidated financial statements; and
  - Reporting social insurance financial information in the U.S. government's consolidated financial statements that includes information from the most recent reports issued by the Social Security and Medicare Trustees.

Various aspects of the matters outlined above are further discussed in applicable sections later in this testimony. Future meetings, with the next meeting planned for May 2002, will enable the JFMIP Principals to reach agreements and monitor progress on strategies critical to the full and successful implementation of federal financial management reform and to provide greater transparency and accountability in managing federal programs and financial resources.

---

## The President's Management Agenda

President Bush has established an agenda for improving the management and performance of the federal government that targets the most apparent deficiencies where the opportunity to improve performance is the greatest. It is no accident that the President's Management Agenda has a strong correlation to GAO's high-risk list. This is just one example of how GAO and OMB have worked constructively to identify key issues deserving increased attention throughout government. As stated in the President's Management Agenda—and we wholeheartedly agree—there are few items more urgent than ensuring that the federal government is well run and results-oriented.

The President's Management Agenda, which is a starting point for management reform, includes improved financial management

---

performance as one of his five governmentwide management goals. Other governmentwide initiatives include strategic management of human capital, competitive sourcing, expanded electronic government, and budget and performance integration.

The results of our audits of the U.S. government's consolidated financial statements helped to lay the foundation for the President's Management Agenda financial management performance initiative. The President's Management Agenda frames the problem this way: "A clean financial audit is a basic prescription for any well-managed organization, yet the federal government has failed all four [now five] audits since 1997. Moreover, most federal agencies that obtain clean audits only do so after making extraordinary labor-intensive assaults on financial records. Without accurate and timely financial information, it is not possible to accomplish the president's agenda to secure the best performance and high measure of accountability for the American people."

In particular, the improved financial performance initiative is aimed at ensuring that federal financial systems produce accurate and timely information to support operating, budget, and policy decisions. Also, this initiative focuses special attention on addressing erroneous payments, which as discussed earlier, is another problem our audit identified.

Under this governmentwide initiative, OMB will work with agencies to improve the timeliness, enhance the usefulness, and ensure the reliability of financial information. The expected result is financial management systems that routinely produce information that is (1) timely, to measure and effect performance immediately, (2) useful, to make more informed operational and investing decisions, and (3) reliable, to ensure consistent and comparable trend analysis over time and to facilitate better performance measurement and decisionmaking. This result is a key to successfully achieving the goals set out by the Congress in the CFO Act and other federal financial management reform legislation.

---

## The Executive Branch Management Scorecard

As we recently testified before this subcommittee,<sup>13</sup> the administration plans to use the Executive Branch Management Scorecard to highlight

---

<sup>13</sup>U.S. General Accounting Office, *Managing for Results: Next Steps to Improve the Federal Government's Management and Performance*, GAO-02-439T (Washington, D.C.: Feb. 15, 2002).

---

agencies' progress in achieving management and performance improvements embodied in the President's Management Agenda. The Executive Branch Management Scorecard grades agencies' performance regarding the five governmentwide initiatives by using broad standards and a red-yellow-green coding system to indicate the level at which agencies are meeting the standards.

In the financial management area, while recognizing the importance of achieving a clean opinion from auditors on financial statements, the scorecard focuses on the fundamental and systemic issues that must be addressed in order to generate timely, accurate, and useful financial information, sound internal structures, and effective compliance systems. The first scorecard's results show dramatically the extent of work remaining across government to improve financial and other management areas. For financial management, most agencies were scored in the red category. This is not surprising, considering the well-recognized need to transform financial management and other business processes at agencies such as DOD, the results of our analyses under FFMIA, and the various financial management operations we have designated as high risk.

Also, central to effectively addressing the federal government's management problems is recognition that the five governmentwide initiatives cannot be addressed in an isolated or piecemeal fashion. As stated in the President's Management Agenda, they are mutually reinforcing. More generally, the initiatives must be addressed in an integrated way to ensure that they drive a broader transformation of the cultures of federal agencies.

Improved financial management, for example, is also a key to successfully achieving other governmentwide initiatives set out in the President's Management Agenda:

- Strategic management of human capital: Financial management reform will require having the right people in CFO leadership positions and enough people with the right skills and knowledge to perform important financial operations.
- Competitive sourcing: For example, accurately knowing the cost for providing goods and services in-house for comparison with private sector performance will be important in making sound sourcing decisions.

- 
- Expanded electronic government: Many e-government applications will likely be financial in nature, interact with financial systems and reporting, and greatly change the internal control environment.
  - Budget and performance integration: It is critical to focus on integrating accounting, budget, and performance information, which the CFO Act requires; reporting the cost of performance, which is essential to successfully implementing GPRA; and providing useful information for setting priorities and making informed budget decisions.

The focus that the administration's scorecard approach brings to improving management and performance, including financial performance, is certainly a step in the right direction. The value of the scorecards is not in the scoring, but in the degree to which scores lead to sustained focus and demonstrable improvement over time. This will depend on continued efforts to assess progress and maintain accountability to ensure that agencies are able to, in fact, improve their performance. It will be important that there be continuous rigor in the scoring process in order for this approach to be credible and effective. Also, it is important to recognize that many of the challenges the federal government faces, such as improving financial management, are long-standing and complex, and will require sustained attention.

---

## Looking Beyond Unqualified Audit Opinions

Across government, there are financial management improvement initiatives that could ultimately lead to an unqualified opinion on the U.S. government's consolidated financial statements. However, accelerating the pace of completing ongoing and planned efforts to implement financial management reform is essential, as shown by reports of inspectors general and their contract auditors indicating that only 3 of the 24 CFO Act agencies had neither a material control weakness, an issue involving compliance with applicable laws and regulations, nor an instance of lack of substantial compliance with FFMLA requirements. While many of the pervasive and generally long-standing material weaknesses we have reported for the past 4 years remain to be fully resolved, some progress continues to be made in addressing the underlying causes of these problems—significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal control.

For fiscal year 2001, 18 of the 24 CFO Act agencies were able to attain unqualified audit opinions on their financial statements, which is the same

---

number of agencies as last year and up from 6 agencies for fiscal year 1996. Also, OMB reported that, for the second consecutive year, all 24 CFO Act agencies met the statutory reporting deadline. Further, two agencies that did not receive unqualified opinions from their auditor last year were able to do so this year, including the Department of Transportation (DOT) and the Department of Justice, which received an unqualified opinion for the first time. However, two other agencies, the National Aeronautics and Space Administration (NASA) and the Federal Emergency Management Agency, were unable to sustain the unqualified opinions received from their auditor last year.

In the case of NASA, as we recently testified<sup>14</sup> before this subcommittee, after 5 years of receiving unqualified opinions on financial statements from its previous independent auditor, the new independent auditor disclaimed an opinion on the agency's fiscal year 2001 financial statements. The fiscal year 2001 audit report also identified a number of significant internal control weaknesses related to accounting for space station material and equipment and to computer security. Finally, the auditor concluded that NASA's financial management systems do not substantially comply with federal financial management systems requirements and applicable federal accounting standards, as required by FFMIA. NASA's financial management difficulties are not new. The weaknesses discussed in the auditor's report are consistent with the findings discussed in our previous reports. Since 1990, we have designated NASA's contract management problems as a high-risk area, due in part to financial management systems problems that make it difficult for NASA to assure contracts are being efficiently and effectively implemented.<sup>15</sup> We have also reported on NASA's misstatement of its Statement of Budgetary Resources, lack of detailed support for amounts reported against certain cost limits, and lack of historical cost data for accurately projecting future cost.<sup>16</sup>

---

<sup>14</sup>U.S. General Accounting Office, *National Aeronautics and Space Administration: Leadership and Systems Needed to Effect Financial Management Improvements*, GAO-02-551T (Washington, D.C.: March 20, 2002).

<sup>15</sup>See, for example, GAO-01-263.

<sup>16</sup>U.S. General Accounting Office, *Major Management Challenges and Program Risks: NASA*, GAO-01-258 (Washington, D.C.: Jan. 2001); U.S. General Accounting Office, *Financial Management: Misstatement of NASA's Statement of Budgetary Resources*, GAO-01-438 (Washington, D.C.: Mar. 30, 2001); and U.S. General Accounting Office, *NASA: International Space Station and Shuttle Cost Limits*, GAO-01-1000R (Washington, D.C.: Aug. 31, 2001).

---

Irrespective of the unqualified opinions on their financial statements, many agencies do not have timely, accurate, and useful financial information and sound controls with which to make informed decisions and to ensure accountability on an ongoing basis. While agencies are making some progress in obtaining unqualified audit opinions on annual financial statements, many of these opinions were obtained by expending significant resources on extensive ad hoc procedures and making billions of dollars in adjustments to derive financial statements months after the end of a fiscal year. Several examples follow. The need for such time-consuming procedures primarily results from inadequate financial management systems.

- Our unqualified opinions on IRS's fiscal years 2001 and 2000 financial statements were made possible by the extraordinary efforts of IRS senior management and staff to develop processes to compensate for serious internal control and systems deficiencies. IRS was again compelled to rely extensively on costly, time-consuming processes; statistical projections; external contractors; substantial adjustments; and monumental human efforts that extended nearly four months after the September 30, 2001, fiscal year-end to derive reliable year-end balances for its financial statements. For example, IRS does not have a detailed record, or subsidiary ledger, for taxes receivable to allow it to track and manage amounts due from taxpayers. To enable it to report a reliable taxes receivable balance in the absence of a subsidiary ledger, IRS has, for the last five years, relied on a complex statistical sampling approach that requires substantial human and financial resources to conduct, takes months to complete, and yields tens of billions of dollars of adjustments. Similarly, IRS does not have an integrated property management system that appropriately records property and equipment additions and disposals as they occur and links costs on the accounting records to the property records. During fiscal year 2001, IRS expensed property additions during the year and then capitalized them at year-end based on analysis of expense records conducted by a contractor.
- DOT's major agencies use the Departmental Accounting and Financial Information System (DAFIS), which cannot produce financial statements based on the information included within the system. As a result, DOT made about 850 adjustments, totaling about \$41 billion, outside DAFIS to prepare the financial statements. These adjustments were recorded in a financial statement module, a tool used to process the adjustments. However, all DOT agencies did not use the financial statement module to prepare the financial statements, and the

---

adjustments were not recorded in DAFIS. The DOT inspector general reported that DOT plans to have a new accounting system fully operational and compliant with accounting standards by January 2003.

- Again, in fiscal year 2001, HHS attained an unqualified opinion on its financial statements. However, system and internal control weaknesses, such as lack of an integrated financial management system, continued to make it difficult for certain HHS components to prepare timely and reliable financial statements. For example, the National Institutes of Health used a manual year-end process to create and post correct Standard General Ledger accounts, generating about 19,000 nonstandard accounting entries with an absolute value of approximately \$348 billion. Also, the Centers for Medicare and Medicaid Services, continued to contract with independent public accounting firms, as it has since FY 1999, to validate contractor receivables. Further, the Administration for Children and Families and the Centers for Disease Control, produced their financial statements using a manually intensive process that required adjusting entries to their general ledgers with an absolute value of approximately \$51 billion and \$2 billion, respectively.
- The Department of Education's auditor expressed a qualified opinion on the department's fiscal year 2001 financial statements, primarily because of weaknesses in the department's financial reporting process. Consistent with prior years, Education relied on work-around procedures to prepare its financial statements, including significant manual adjustments, due to deficiencies in the current general ledger system and the lack of a fully integrated financial management system. Because of errors that existed in prior years, the department performed extensive analysis of certain general ledger account balances during fiscal year 2001, which resulted in manual adjustments to correct certain general ledger balances. However, the auditor noted that there were errors in certain manual adjustments that had been processed and approved by the department, resulting in additional manual adjustments being posted to the financial statements.
- The Department of Veterans Affairs (VA) received unqualified audit opinions on its financial statements for fiscal years 2000 and 2001, but producing them required significant efforts to assemble, compile, and review the necessary financial information. In many cases, significant manual work-around procedures and "cuff" or out-of-date feeder systems are used, as VA has not yet completed its transition to a fully integrated financial management system. According to VA's auditors,

---

timely account reconciliations were not consistently prepared at the department's medical centers and assets were not timely capitalized. Also, a significant number of manual adjustments were made during the year-end closing process.

Situations such as these demonstrate the tremendous efforts, lasting 5 months or more, that many agencies use to produce annual financial statements. These agencies undertake far more work to prepare financial statements, beginning at the close of a fiscal year, than would be necessary if they had financial systems in place to routinely provide the data. Information to compile agency financial statements should flow from their financial management systems. (The need for agencies to improve financial management systems is further discussed later in this testimony.)

At the same time and as agreed to by the JFMIP Principals, there is a need to accelerate the timeliness of providing audited financial statements. March 1 is the current statutory deadline for the 24 CFO Act agencies to submit audited financial statements, 5 months after the close of the fiscal year. For fiscal year 2001 reporting, OMB pushed this time frame ahead to February 27. Beginning with fiscal year 2004, OMB will require these agencies to issue audited financial statements by November 15, 6 weeks after the fiscal year end. While this is important for timely financial reporting, it will be difficult for some agencies to sustain unqualified audit opinions and still meet the accelerated time frame for submitting audited financial statements.

IRS is a case in point. With the extraordinary efforts described above, IRS found it extremely difficult to meet the February 27 reporting timeline required by OMB for fiscal year 2001. If IRS is to meet the November 15 deadline and sustain an unqualified opinion on its financial statements, the tremendous amount of hard work and commitment that IRS has demonstrated in recent years will no longer be sufficient to achieve this goal unless accompanied by systemic changes in how IRS processes transactions, maintains its financial records, and reports its financial results.

It will be difficult for agencies to continue to rely on significant costly and time-intensive manual efforts to achieve or maintain unqualified opinions until automated, integrated processes and systems are implemented that readily produce the necessary information. As a result, many agencies must accelerate their efforts to improve underlying financial management systems and controls, which is consistent with reaching the financial

---

management success measures envisioned by the JFMIP Principals and called for by the President's Management Agenda. If agencies continue year after year to rely on significant costly and time-intensive manual efforts to achieve or maintain unqualified opinions without such improvements, this practice can serve to mislead the public as to the true status of the agency's financial management capabilities. An unqualified opinion will become an accomplishment without much substance.

---

## Addressing Major Impediments to Unqualified Opinion on Consolidated Financial Statements

As I mentioned earlier, for the past 5 fiscal years, the federal government has been required to prepare, and have audited, consolidated financial statements. Successfully meeting this requirement is tightly linked to the requirement for the 24 CFO Act agencies to also have audited financial statements. This has stimulated extensive cooperative efforts and considerable attention by agency chief financial officers, inspectors general, Treasury and OMB officials, and the General Accounting Office. With the benefit of several years' experience by the government in having the required financial statements subjected to audit, the time has come to focus even more intensified attention on the most serious obstacles to achieving an unqualified opinion on the U.S. government's consolidated financial statements. In this regard, the JFMIP Principals have discussed plans and strategies for addressing impediments to an unqualified opinion on the U.S. government's consolidated financial statements.

---

## Reforming Financial Management at DOD

This year, upon early implementation of certain provisions of the National Defense Authorization Act for fiscal year 2002,<sup>17</sup> DOD reported that the department's financial management systems are not able to provide adequate evidence supporting material amounts in its financial statements. DOD asserted that it is unable to comply with applicable financial reporting requirements for (1) property, plant, and equipment, (2) inventory and operating materials and supplies, (3) military retirement health care actuarial liability, (4) environmental liabilities, (5) intragovernmental eliminations and related accounting adjustments, and (6) cost accounting

---

<sup>17</sup>The Fiscal Year 2002 National Defense Authorization Act contains provisions that will provide a framework for redirecting the department's resources from the preparation and audit of financial statements to improvement of DOD's financial management systems and financial management policies, procedures, and internal controls. Under this new legislation, the department will also be required to report to the Congress on how resources have been redirected and the progress that has been achieved.

---

by suborganization/responsibility segment and major program. Based largely on DOD's assertion, the DOD inspector general disclaimed an opinion on DOD's financial statements for fiscal year 2001 as it had for the previous 5 fiscal years. DOD's financial management deficiencies and reporting weaknesses substantially impair our ability to determine the reliability of the financial information reported in the government's overall financial reports. Until DOD corrects these material weaknesses, our ability to express an unqualified opinion on the U.S. government's consolidated financial statements will be impeded.

As I previously stated, to date, none of the military services or major DOD components has passed the test of an independent financial audit because of pervasive weaknesses in DOD's financial management systems, operations, and internal control, including an inability to compile financial statements that comply with U.S. generally accepted accounting principles. The department has made progress in a number of areas, but is far from solving a range of serious financial management problems. Their resolution, however, is key to having auditable consolidated financial statements because DOD had budget authority of \$352 billion for fiscal year 2001, or about 18 percent of the entire federal budget, and is accountable for a vast amount of government assets worldwide.

Despite progress, ineffective asset accountability and lack of effective internal controls continue to adversely affect visibility over DOD's estimated \$1 trillion investment in weapon systems and inventories. These weaknesses can affect the department's ability to ensure that materials are on hand when needed and its ability to prevent the purchase of assets already on hand. Further, unreliable cost and budget information related to a reported over \$1.4 trillion of reported liabilities and about \$735 billion<sup>18</sup> of net costs negatively affects DOD's ability to effectively measure performance, reduce costs, and maintain adequate fund control.

---

<sup>18</sup>This amount was reported on the department's fiscal year 2001 financial report, whereas the \$352 billion discussed in the preceding paragraph represents an estimate of the amount of budget authority shown in the documents accompanying the President's budget submission. The principal difference is attributable to a \$389 billion increase in the military postretirement health benefits liability under new legislation extending benefits to Medicare-eligible military retirees and their beneficiaries. Other differences between these amounts are the result of (1) timing differences in the receipt of budgetary resources and recording associated expenses and (2) unknown errors in the amounts shown in the financial statements, which were unauditable.

---

As part of our constructive engagement approach with DOD, I met with Secretary Rumsfeld last summer to provide our perspectives on the underlying causes of the problems that have impeded past reform efforts at the department and to discuss options for addressing these challenges. The underlying causes discussed were

- a lack of sustained top-level leadership and management accountability for correcting problems;
- deeply embedded cultural resistance to change, including military service parochialism and stovepiped operations;
- a lack of results-oriented goals and performance measures and monitoring; and
- inadequate incentives for seeking change.

In this regard, I also attended the initial March 15, 2002, meeting of DOD's Business Practices Implementation Board, which is composed of outside experts to advise the department on its effort to address these underlying causes.

As we testified before this subcommittee last month and in May 2001,<sup>19</sup> our experience has shown there are several key elements that collectively would enable the department to effectively address the underlying causes of its inability to resolve its long-standing financial management problems. These elements, which are key to any successful approach to financial management reform, include

- addressing the department's financial management challenges as part of a comprehensive, integrated, DOD-wide business process reform;
- providing for sustained leadership by the Secretary of Defense and resource control to implement needed financial management reforms;

---

<sup>19</sup>U.S. General Accounting Office, *DOD Financial Management: Integrated Approach, Accountability, Transparency, and Incentives Are Keys to Effective Reform*, GAO-02-537T (Washington, D.C.: Mar. 2002) and U.S. General Accounting Office, *DOD Financial Management: Integrated Approach, Accountability, and Incentives Are Keys to Effective Reform*, GAO-01-681T (Washington, D.C.: May 8, 2001).

- 
- establishing clear lines of responsibility, authority, and accountability for such reform tied to the Secretary;
  - incorporating results-oriented performance measures and monitoring tied to financial management reforms;
  - providing appropriate incentives or consequences for action or inaction;
  - establishing an enterprisewide system architecture to guide and direct financial management modernization investments; and
  - ensuring effective oversight and monitoring.

The department has acknowledged the need for fundamental reform of its business practices. Specifically, the department's September 30, 2001, *Quadrennial Defense Review* reported that: "While America's businesses have streamlined and adopted new business models to react to fast-moving changes in markets and technologies, the Defense Department has lagged behind without an overarching strategy to improve its business practices."

Action on many of the key areas central to successfully achieving desired financial management and related business process transformation goals—particularly those that rely on longer term systems improvements—will take a number of years to fully implement. Secretary Rumsfeld has estimated that his envisioned transformation may take 8 or more years to complete. Consequently, both long-term actions focused on the Secretary's envisioned business transformation and short-term actions focused on improvements within existing systems and processes will be critical going forward. Short-term actions in particular will be critical if the department is to achieve the greatest possible accountability over existing resources and more reliable data for day-to-day decisionmaking while longer-term systems and business process reengineering efforts are under way.

Beginning with the Secretary's recognition of the need for a fundamental transformation of the department's business processes, and building on some of the work begun under past administrations, DOD has taken a number of positive steps in many of these key areas. For example, DOD has taken action to set aside \$100 million for financial modernization and, as discussed previously, established a number of top-level committees, councils and boards to help guide its financial transformation efforts. At the same time, the challenges remaining in each of these key areas are daunting. The JFMIP Principals have invited DOD Comptroller Zakheim to

---

their planned May 2002 meeting to discuss the department's transformation effort and to begin a constructive engagement with DOD on this important initiative.

---

### Focusing on Intragovernmental Transactions

For several years, OMB and Treasury have required the CFO Act agencies to reconcile selected intragovernmental activity and balances with their trading partners. However, numerous agencies did not fully perform such reconciliations for fiscal year 2000. Beginning with fiscal year 2001, OMB and Treasury required agency chief financial officers to report on the extent and results of intragovernmental activity and balances reconciliation efforts. The inspectors general reviewed these reports and communicated the results of their reviews to OMB, Treasury, and GAO. A substantial number of the CFO Act agencies did not fully perform the required reconciliations for fiscal year 2001, citing reasons such as (1) trading partners' not providing needed data, (2) limitations and incompatibility of agency and trading partner systems, and (3) human resource issues. For fiscal years 2001 and 2000, amounts reported for agency trading partners for certain intragovernmental accounts were significantly out of balance. In addition, solutions will be required to resolve significant differences reported in other intragovernmental accounts, primarily related to appropriations.

To help address certain issues that contributed to the out-of-balance condition for intragovernmental activity and balances, OMB has stated that it is implementing the recommendations included in a study conducted for the JFMIP in fiscal year 2001. OMB is also pursuing other changes to address core problems in this area, such as enhancing governmentwide business rules for transactions among trading partners, requiring quarterly reconciliations of intragovernmental activity and balances, and modifying certain standard general ledger accounts required to be used by federal agencies. Resolving this problem remains a difficult challenge and will require commitment by the CFO Act agencies and continued strong leadership by OMB.

---

### Preparing the Consolidated Financial Statements

The government did not have adequate systems, controls, and procedures to properly prepare its consolidated financial statements. Also, disclosure of certain financial information was not presented in the consolidated financial statements in conformity with U.S. generally accepted accounting principles.

---

Elimination of  
Intragovernmental Activity and  
Balances

Consolidated financial statements are intended to present the results of operations and financial position of the components that comprise a reporting entity as if the entity were a single enterprise. When preparing the consolidated financial statements, the preparer must eliminate intragovernmental activity and balances between the agencies. Because of agencies' problems in handling their intragovernmental transactions, Treasury's ability to eliminate these transactions is impaired. Significant differences reported in intragovernmental accounts as noted above have been identified. Intragovernmental activity and balances are "dropped" or "offset" in the preparation of the consolidated financial statements rather than eliminated through balanced accounting entries. This contributes to the government's inability to determine the impact of these differences on amounts reported in the consolidated financial statements.

Reconciling Operating Results  
with Budget Results

The government did not have a process to effectively identify and report items needed to reconcile adequately the operating results, which for fiscal year 2001 showed a net operating cost of \$514.8 billion, to the budget results, which for the same period showed a unified surplus of \$127 billion.

Consolidated Financial  
Statement Compilation

The government could not adequately ensure that the information for each agency that was included in the consolidated financial statements was consistent with the underlying agency financial statements. This problem is compounded by the need for broad changes in the structure of the government's Standard General Ledger (SGL) accounts and the process for maintaining the SGL. For example, changes are needed that will result in direct alignment by SGL account from agencies' financial statement line items to like items reported in the consolidated financial statements.

---

To make the fiscal year 2001 consolidated financial statements balance, Treasury recorded a net \$17.3 billion decrease to net operating cost on the Statement of Operations and Changes in Net Position, which it labeled unreconciled transactions. For the prior fiscal year, a net \$4.8 billion in unreconciled transactions was recorded as a decrease to net operating revenue in the accompanying consolidated financial statements.<sup>20</sup> An additional net \$3.9 billion and \$.2 billion of unreconciled transactions were improperly recorded in net cost for fiscal years 2001 and 2000, respectively. Treasury attributes these net unreconciled transaction amounts primarily to the government's inability to properly identify and eliminate transactions between governmental entities, agency adjustments that affected net position, and other errors. However, Treasury was unable to adequately identify and explain the gross components of such amounts. Unreconciled transactions also may exist because the government does not have effective controls over reconciling net position.<sup>21</sup>

The net position reported in the consolidated financial statements is derived by subtracting liabilities from assets, rather than through balanced accounting entries. Further, the process used to prepare the consolidated financial statements requires significant human and financial resources and does not adequately leverage the existing work and work products resulting from federal agencies' audited financial statements.

Treasury plans to develop a new system and procedures to prepare the consolidated financial statements. These actions are intended to, among other things, directly link information from agencies' financial statements to amounts reported in the consolidated financial statements and facilitate the reconciliation of net position.

---

<sup>20</sup>Last year a net \$7.3 billion in unreconciled transactions was recorded as an increase in net position. As discussed in footnote 6 of this testimony, numerous amounts previously reported for fiscal year 2000 have been restated in the U.S. government's consolidated financial statements for fiscal years 2001 and 2000, including this amount.

<sup>21</sup>In prior years, the government reported unreconciled transactions as a change in net position. Although the government was unable to determine how much of the unreconciled transactions, if any, relate to operations, it reported unreconciled transactions as a component of net operating revenue/(cost) in the U.S. government's consolidated financial statements for fiscal years 2001 and 2000.

---

---

## Improving Financial Management Systems

The inability to produce the data needed to efficiently and effectively manage the day-to-day operations of the federal government and provide accountability to taxpayers and the Congress has been a long-standing weakness at most federal agencies. The President's Management Agenda recognizes that the central challenge to producing reliable, useful, and timely data throughout the year and at year-end is overhauling the government's financial management information systems. The CFO Act calls for the modernization of financial management systems, including the systematic measurement of performance, the development of cost information, and the integration of program, budget, and financial information.

FFMIA builds on the CFO Act by emphasizing the need for agencies to have systems that can generate timely, accurate, and useful information with which to make informed decisions and to ensure accountability on an ongoing basis. FFMIA requires the 24 departments and agencies covered by the CFO Act to implement and maintain financial management systems that comply substantially with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the U.S. Standard General Ledger (SGL) at the transaction level. These requirements are at the center of the financial management success measures expressed by the JFMIP Principals and are key elements for scoring agencies' financial management performance using the Executive Branch Management Scorecard.

For fiscal year 2001, auditors for 20 of the 24 CFO Act agencies reported that agencies' financial management systems did not substantially comply with one or more of FFMIA's three requirements.<sup>22</sup> For the remaining four CFO Act agencies (the Departments of Energy and Labor, GSA, and SSA), auditors provided negative assurance, meaning that nothing came to their attention indicating these agencies' financial management systems do not meet FFMIA requirements. The auditors for these four agencies did not definitively state whether these agencies' systems substantially complied with FFMIA's requirements.

In this regard, OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*, does not require auditors to make an affirmative

---

<sup>22</sup>GAO plans to report to the Congress, by October 1, 2002, on agencies' FFMIA implementation for fiscal year 2001, as required by FFMIA.

---

statement regarding an agency's financial management system's substantial compliance with FFMIA, but rather permits auditors to report negative assurance, meaning that their report can be based on limited audit testing that disclosed no substantial instances of FFMIA noncompliance. If readers of the audit report do not understand this distinction, which is important in terms of how much audit testing is required, they may have a false impression that the auditor is stating that they found the systems to be substantially compliant. To provide positive assurance, or an opinion, which is what we believe the law requires, auditors need to perform sufficient testing to determine whether the system is in substantial compliance.

Noncompliance with FFMIA is indicative of the overall continuing poor condition of many financial management systems across government.<sup>23</sup> We have consistently reported over the past few years that the reasons for systems noncompliance included nonintegrated financial management systems, inadequate reconciliation procedures, untimely recording of financial information, noncompliance with the SGL, lack of adherence to the accounting standards, and weak security controls over information systems. We have also reported that agency remediation plans, required by FFMIA, may not adequately address the system deficiencies.

While agencies continue to make some progress in addressing their financial management systems weaknesses, the serious shortcomings reported for these systems result in the lack of reliable financial information needed for managing day-to-day operations effectively, efficiently, and economically; measuring program performance; executing the budget; maintaining accountability; and preparing financial statements. Having such financial information is the goal of FFMIA and the CFO Act, necessary for implementing GPRA, and critical to the transition to a more results-oriented federal government as envisioned in the President's Management Agenda.

For example, agency financial management systems are required to produce information on the full cost of programs and projects. This is not a new expectation—the requirement for managerial cost information has been in place for more than a decade, since 1990, under the CFO Act, and since 1998 stemming from applicable accounting standards. Yet, some

---

<sup>23</sup>U.S. General Accounting Office, *Financial Management: FFMIA Implementation Critical for Federal Accountability*, GAO-02-29 (Washington, D.C.: Oct. 1, 2001).

---

agencies are only able to provide cost accounting information at the end of the fiscal year through periodic cost surveys. The lack of timely information on the full cost of operations precludes meaningful data that is needed to make resource allocation choices, reach contracting-out decisions, determine program efficiencies, assess user fees, and report performance.

To remedy these deficiencies and carry out the President's Management Agenda for improving financial management, OMB and the CFO Act agencies will need to aggressively and rigorously collaborate. This will be critical, since overhauling agency financial management systems is a difficult challenge. Our work to identify financial management best practices in world-class organizations<sup>24</sup> has identified key factors for successfully modernizing financial systems, including (1) reengineering business processes in conjunction with implementing new technology, (2) developing systems that support the partnership between finance and operations, and (3) translating financial data into meaningful data. We identified other financial management best practices as well, such as (1) providing clear strong executive leadership, (2) making financial management an entitywide priority, and (3) building a culture of control and accountability.

The size and complexity of many federal agencies and the discipline needed to overhaul or replace their financial management systems present a significant challenge—not simply a challenge to overcome a technical glitch, but a demanding management challenge that requires attention from the highest levels of government along with sufficient human capital resources to effect lasting change. We recognize that it will take time, investment, and sustained emphasis on correcting deficiencies to improve federal financial management systems to the level required by FFMIA. The JFMIP Principals' leadership, commitment, and oversight will be important to provide the needed impetus to meet this challenge.

---

## Protecting The Public Interest

Two audit matters have recently come to the fore and are key to protecting the public interest. One matter involves auditors' responsibility for reporting on internal control, and the other concerns auditor independence.

---

<sup>24</sup>U.S. General Accounting Office, *Executive Guide: Creating Value Through World-class Financial Management*, GAO/AIMD-00-134 (Washington, D.C.: Apr. 2000).

---

---

## Auditors' Responsibility for Reporting on Internal Control

We have long believed that auditors have an important responsibility to provide an opinion on the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations. Currently, this is not required by American Institute of Certified Public Accountants (AICPA) auditing standards or by OMB in its guidance<sup>25</sup> to auditors conducting federal agency financial statement audits.

For financial statements audits that we conduct—which include the U.S. government's consolidated financial statements, the financial statements of the IRS, the Schedules of Federal Debt managed by the Bureau of Public Debt, and the financial statements of the Federal Deposit Insurance Corporation and numerous small entities' operations and funds—we issue a separate opinion on the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations.

For years we have provided opinions on internal control effectiveness because of the importance of internal control to protecting the public's interest. Our reports have engendered major improvements in internal control. As you might expect, as part of the annual audit of our own financial statements, we practice what we recommend to others and contract with a CPA firm for both an opinion on our financial statements and an opinion on the effectiveness of our internal control over financial reporting and compliance with applicable laws and regulations.

Recently, GAO and the President's Council on Integrity and Efficiency jointly issued the *Financial Audit Manual* to provide guidance to auditors conducting federal agency financial statement audits. This manual calls for these auditors to test internal control over financial reporting and compliance with applicable laws and regulations, and thus provides a foundation for issuing a separate opinion on the effectiveness of internal control. Although OMB requires testing of these internal controls, auditors are not required to provide an opinion on internal control effectiveness. However, we found that 3 of the 24 CFO Act agency auditors (those for GSA, SSA, and the Nuclear Regulatory Commission) provided an opinion on the effectiveness of internal control as of September 30, 2001.

---

<sup>25</sup>Office of Management and Budget, *Audit Requirements for Federal Financial Statements*, Bulletin 01-02 (Washington, D.C.: Oct. 19, 2000).

---

Also, the JFMIP Principals have agreed that a measure of financial management success is for an agency to have no material control weaknesses. By giving assurance about internal control, auditors of federal financial statements can better serve their clients and other financial statements users and protect the public interest by having a greater role in providing assurances of the effectiveness of internal control in deterring fraudulent financial reporting, protecting assets, and providing an early warning of internal control weaknesses.

---

## Auditor Independence

The independence of auditors—both in fact and appearance—is critical to the credibility of financial reporting. Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to federal entities. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide.

These concepts, which I strongly believe are in the public interest, are reflected in the revisions to auditor independence requirements for government audits,<sup>26</sup> which GAO recently issued as part of *Government Auditing Standards*.<sup>27</sup> The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.<sup>28</sup> The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that

---

<sup>26</sup>U.S. General Accounting Office, *Government Auditing Standards, Amendment No. 3, Independence*, GAO-02-388G (Washington, D.C.: Jan. 2002).

<sup>27</sup>*Government Auditing Standards* was first published in 1972 and is commonly referred to as the “Yellow Book.” It covers federal entities and those organizations receiving federal funds. Various laws require compliance with the standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

<sup>28</sup>The Advisory Council includes 20 experts in financial and performance auditing and reporting—drawn from all levels of government, academia, private enterprise, and public accounting—who advise the Comptroller General on *Government Auditing Standards*.

- 
- auditors should not perform management functions or make management decisions, and
  - auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of these principles should be applied using a substance-over-form determination. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate these principles; however, in most circumstances certain additional safeguards would have to be met. For example: (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party, and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regarding auditors' providing certain bookkeeping or record keeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA.

The focus of these changes to the government auditing standards is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities and entities that receive federal funding. However, these standards apply only to audits of federal entities and those organizations receiving federal funds, and not to auditors of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA will raise its independence standards to those contained in the new standard in order to eliminate any inconsistency between this standard and their current standards.

The new independence standard is the first of several steps GAO has planned in connection with nonaudit services covered by government auditing standards. In May 2002, we plan to issue a question and answer document concerning our independence standard, and I will ask my Advisory Council on Government Auditing Standards to review and monitor this area to determine what, if any, additional steps may be appropriate. In addition, the JFMIP Principals have agreed that the 24 major federal departments and agencies covered by the CFO Act should have audit committees. The scope, structure, and timing of this new

---

requirement will be determined over the next several months. This will include determining what role these audit committees might play in connection with nonaudit services.

---

## Preparing to Meet Tomorrow's Fiscal Needs

Several of the matters I previously discussed related to preparing to meet tomorrow's fiscal needs warrant repeating. The requirement for timely, accurate, and useful financial and performance management information is greater than ever. Both the long-term fiscal pressures created by the retirement of the baby boom generation and the new commitments undertaken in the aftermath of September 11 sharpen the need to look at competing claims on federal budgetary resources and new priorities. In previous testimony, I noted that it should be the norm to reconsider the relevance or "fit" of any federal program or activity in today's world and for the future.<sup>29</sup> Such a fundamental review is necessary both to increase fiscal flexibility and to make government fit the modern world. Stated differently, there is a need to consider what the proper role of the federal government should be in the 21st century and how the government should do business in the future.

As we look ahead we face an unprecedented demographic challenge. A nation that has prided itself on its youth will become older. Between now and 2035, the number of people who are 65 or over will double. As the share of the population over 65 climbs, federal spending on the elderly will absorb larger and ultimately unsustainable shares of the federal budget. Federal health and retirement spending are expected to surge as people live longer and spend more time in retirement. In addition, advances in medical technology are likely to keep pushing up the cost of providing health care. Moreover, the baby boomers will have left behind fewer workers to support them in retirement, prompting a slower rate of economic growth from which to finance these higher costs. Absent substantive change in related entitlement programs, large deficits will return, requiring a combination of unprecedented spending cuts in other areas, and/or unprecedented tax increases, and/or substantially increased borrowing from the public (or correspondingly less debt reduction than

---

<sup>29</sup>U.S. General Accounting Office, *Budget Issues: Long-Term Fiscal Challenges*, GAO-02-467T (Washington, D.C.: Feb. 27, 2002) and U.S. General Accounting Office, *Budget Issues: Effective Oversight and Budget Discipline are Essential—Even in a Time of Surplus*, GAO/T-AIMD-00-73 (Washington, D.C.: Feb. 1, 2000).

---

would otherwise have been the case). These trends have widespread implications for our society, our economy, and the federal budget.

On March 26, 2002, the Trustees of the Social Security and Medicare trust funds reported on the current and projected status of these programs over the next 75 years. The Trustees' reports highlight the need to address the long-term fiscal challenges facing the nation. The Trustees state that, while the near-term financial conditions have improved slightly since last year's reports, the programs continue to face substantial financial challenges in the not-too-distant future that need to be addressed soon. Once again, the Trustees underscored the fact that the most significant implication of these findings is that both Social Security and Medicare need to be reformed and strengthened at the earliest opportunity. The Trustees also stated that Medicare faces financial difficulties that in many ways are more severe than those confronting Social Security.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to take action entails risks. First, we lose an important window where today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. Second, we lose the opportunity to reduce the burden of interest in the federal budget, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Third, and most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift.

In a closely related matter, I have previously testified<sup>30</sup> before this subcommittee on the need to synchronize the timing of the Trustees' reports with agency and consolidated financial statements. Once again, the U.S. government's consolidated financial statements reported an update of key indicators of the financial status of the Social Security and Medicare trust funds from the Trustees' reports. The Trustees issued their reports the same week as the consolidated financial statements. Without this update, the government would have provided two different reports on the

---

<sup>30</sup>U.S. General Accounting Office, *Auditing the Nation's Finances: Fiscal Year 1999 Results Continue to Highlight Major Issues Needing Resolution*, GAO/T-AIMD-00-137 (Washington, D.C.: Mar. 31, 2000).

---

sustainability of these important programs, which could cause confusion and reduce confidence in the credibility of the U.S. government's consolidated financial statements. This updated information will not be available when the U.S. government's consolidated financial statements are issued on an accelerated basis, beginning with fiscal year 2004. The JFMIP Principals are considering ways to ensure that reports issued by the Social Security and Medicare Trustees, agency financial statements, and the U.S. government's consolidated financial statements present social insurance financial information that is consistent and more timely. In our view, the Congress may need to enact legislation that will require earlier reporting and issuance of the Trustees' reports in order to allow for timely social insurance information to be included in agencies' and the U.S. government's consolidated financial statements.

While addressing the challenges of Social Security and Medicare is key to ensuring future fiscal flexibility, a fundamental review of all programs and operations can create much-needed fiscal flexibility to address emerging needs. As I have stated previously, it is healthy for the nation periodically to review and update its programs, activities, and priorities.<sup>31</sup> Many programs were designed years ago to respond to earlier challenges. Ultimately, we should strive to hand to the next generations the legacy of a government that is effective and relevant to a changing society—a government as free as possible of outmoded commitments and operations that can inappropriately encumber the future.

A reexamination of existing programs and activities could help weed out programs that have proven to be outdated or persistently ineffective or alternatively could prompt us to update and modernize activities through such actions as improving program targeting and efficiency, consolidation, or reengineering of processes and operations. Such a review should not be limited to only spending programs but should include the full range of tools of governance that the federal government uses to address national objectives such as loans, guarantees, tax expenditures, and regulations.

---

<sup>31</sup>GAO/T-AIMD-00-73

---

In the last decade the Congress put in place a series of laws designed to improve information about cost and performance. This framework and the information it provides can help structure and inform the debate about what the federal government should do. In addition, GAO has identified a number of areas warranting reconsideration based on program performance, targeting, and costs. Every year, we issue a report identifying specific options, many scored by the Congressional Budget Office, for congressional consideration stemming from our audit and evaluation work.<sup>32</sup> This report provides opportunities for (1) reassessing objectives of specific federal programs, (2) improved targeting of benefits, and (3) improving the efficiency and management of federal initiatives.

Today the Congress and President Bush face the challenge of sorting out these many claims on the federal budget without the fiscal benchmarks that guided us through the years of deficit reduction into surplus. However, it is still the case that the federal government needs a decision-making framework that permits it to evaluate choices against both today's needs and the longer-term fiscal future that will be handed to future generations. As a way to frame the debate, targets can remind us that today's decisions are not only about current needs but also about how fiscal policy affects the choices over the longer-term. Other nations have found it useful to embrace broader targets such as debt-to-GDP ratios, or surpluses equal to a percent of GDP over the business cycle. To work over time targets should not be rigid—it is in the nature of things that they will sometimes be missed. Reaching a target is not a straight line but an iterative process. The other nations we have studied have found that targets prompted them to take advantage of windows of opportunity to save for the future and that decisionmakers must have flexibility each year to weigh pressing short-term needs and adjust the fiscal path without abandoning the longer-term framework.

The events of the past year have served to highlight the benefits of fiscal flexibility. Addressing the long-term drivers in the budget is essential to preserving any flexibility in the long term. In the nearer term a fundamental review of existing programs and operations can also create much-needed fiscal flexibility. In this regard, we must determine how best to address the necessary structural challenges in a reasonably timely

---

<sup>32</sup>U.S. General Accounting Office, *Supporting Congressional Oversight: Framework for Considering Budgetary Implications of Selected GAO Work*, GAO-01-447 (Washington, D.C.: Mar. 9, 2001).

---

manner in order to identify specific actions that need to be taken. As stewards of our nation's future, we must begin to prepare for tomorrow.

---

## Closing Comments

Our report on the U.S. government's consolidated financial statements for fiscal years 2001 and 2000 highlights the need to continue addressing the government's serious financial management weaknesses. Looking beyond current progress by agencies in attaining unqualified opinions on financial statements, it will be essential for the government to begin moving away from the extraordinary efforts many agencies now use to prepare financial statements and toward giving prominence to strengthening the government's financial systems, reporting, and controls. This approach becomes even more critical as the government progresses to an accelerated financial statement reporting time frame, and it is the only way the government can meet the end goal of making timely, accurate, and useful financial information routinely available to the Congress, other policymakers, and the American public.

The requirement for timely, accurate, and useful financial and performance management information is greater than ever, as the Congress and the administration prepare to meet tomorrow's fiscal challenges. This type of financial information is central to managing the government's operations more efficiently, effectively, and economically and in supporting GPRA. Moreover, meaningful financial and performance information can form the basis for reconsidering the relevance or "fit" of any federal program or activity in today's world and for the future.

In closing Mr. Chairman, I want to underscore the importance of the additional impetus provided by President Bush through his President's Management Agenda and the Executive Branch Management Scorecard for coming to grips with federal financial management problems, indeed management problems across the board. Regarding DOD in particular, Secretary of Defense Rumsfeld's vision and approach for transforming the department's full range of business processes is serious and encouraging. These efforts will be key to fulfilling the President's Management Agenda and addressing the largest obstacle to an unqualified opinion on the U.S. government's consolidated financial statements. The cooperative efforts spearheaded by the JFMIP Principals have been most encouraging in developing the short- and long-term strategies and plans necessary to address many of the problems I have discussed this morning. In addition, GAO has probably never had a better working relationship with OMB and cabinet level and other key officials on a range of "good government issues"

---

that are of critical importance and are inherently non-partisan in nature. While these and other factors provide an enhanced likelihood for success, in the end it is results that count.

Finally, I want to reiterate the value of sustained congressional interest in these issues, as demonstrated by this hearing and those you have held over the past several years to oversee financial management reform. It will also be key that the appropriations, budget, authorizing, and oversight committees hold agency top leadership accountable for resolving these problems and that they support improvement efforts.

---

## Contacts

For further information regarding this testimony, please contact Jeffrey C. Steinhoff, Managing Director, and Gary T. Engel, Director, Financial Management and Assurance, at (202) 512-2600.